The future of lease accounting

Right to respond

The exposure draft generated huge interest and attracted nearly 800 comment letters.

Although some constituents were supportive of the Boards’ efforts to develop a single, principles-based, converged and less complex lease accounting standard, almost all expressed significant concerns over the technical content and complexity of the proposals in the exposure draft.

The Boards have started 2011 by trying to tackle the key issues common to lessee and lessor accounting including:

- the definition of a lease;
- types of leases;
- lease term; and
- variable lease payments.

Resolving these issues will not be easy.

Casual observers may be surprised to hear that there is still significant uncertainty over the simple question: what is a lease? A clear answer to this question is essential if a new standard under which lease contracts are on balance sheet while service contracts are off balance sheet is to be implemented robustly. The Boards will conduct outreach activities on the components of a proposed new definition.

The Boards’ tentative decision that there are two types of leases, finance leases and other-than-finance leases, may also raise a few eyebrows. Again, this is a serious question, central to the effect of the proposals on financial statements.

Many will see the Boards’ tentative decisions to consider a ‘reasonably certain’ recognition threshold for lease term and a high recognition threshold for some contingent rentals as a step in the right direction. Some may crave even greater simplification. However, the willingness of the Boards to reconsider some of the exposure draft’s more controversial proposals, and the Boards’ emphasis on further outreach activities, is welcome.

One thing is certain: much work remains before the Boards’ stated deadline of June 2011.
Feedback on lease accounting proposals

In addition to the nearly 800 comment letters received by the Boards in response to the exposure draft, feedback on the lease accounting proposals also was solicited via a series of roundtables, preparer workshops, outreach meetings and other activities. Throughout the outreach activities, constituents generally were supportive of the Boards’ efforts to develop a single, principles-based, converged and less complex lease accounting standard. However, despite broad support for the overall goals of the project, many constituents expressed significant concerns over the technical content and complexity of the proposals in the exposure draft. Many of these concerns related to the definition of a lease, lease term, variable lease payments, profit or loss recognition pattern and lessor accounting models. A more detailed summary of the comment letter responses is available on the IASB’s website.

The road ahead

It has been more than four years since the lease project was taken onto the Boards’ agenda. However, it’s fair to say that significant uncertainty remains as to whether the Boards will achieve their original goal of a single, principles-based, converged and less complex approach to lease accounting. We are now four months away from the Boards’ self-imposed project deadline of 30 June 2011. The Boards have acknowledged that in order to issue a high quality, comprehensive lease accounting standard within that timeframe, they will need to deliberate and reach conclusions on a long list of key issues. This list includes the five high priority items highlighted in the feedback section above as well as:

- measurement, including discount rate considerations, initial direct costs, foreign exchange, impairment and revaluation considerations;
- inception date vs commencement date, including when to recognise a lease, accounting between inception and commencement of a lease and consideration of build-to-suit leases;
- consideration of other leasing arrangements, including accounting for subleases and sale and leaseback transactions;
- accounting for lease modification and extinguishment;
- lease incentives, leasehold improvements and restoration obligations;
- presentation and disclosure considerations;
- consequential amendments and the impact on investment property and business combinations;
- transitional issues, including the impact on first-time adopters and consideration of full retrospective application;
- considerations for private companies, including transitional issues, and implications for not-for-profit entities; and
- cost/benefit considerations of the proposals as a whole.

The sheer number and significance of issues to be addressed by the Boards will place substantial strain on the Boards’ ability to publish a final comprehensive lease accounting standard in the second quarter of 2011. Time will tell if the final requirements are comprehensive or focused on fixing the perceived weakness in current lessee accounting.

Recent developments

Lessor accounting

As noted in our comment letter, the lessor accounting proposals in the exposure draft were substantially less developed than the lessee proposals. The Boards devoted substantially more time to the lessee right-of-use model in the earlier discussion paper process as compared to the lessor proposals that the Boards rushed to include in the exposure draft. In January 2011 the Boards agreed that more work needs to be done to address the shortfalls of the lessor accounting proposals and considered whether to:

- redeliberate issues raised about the lessor approach as proposed in the exposure draft at the same time as lessee issues are redeliberated with the aim to release one comprehensive lease accounting standard;
- retain current IFRS/US GAAP guidance for lessors with minor updates; or
- redeliberate both lessee and lessor issues initially, but limit lessor accounting discussions to only those issues that are critical to both lessees and lessors.

The Boards decided to limit their discussion of lessor accounting to issues that are critical to both lessees and lessors. This will allow more time to assess the path forward for lessor accounting. As the redeliberations progress, the Boards will decide whether changes to the lessor accounting model in IAS 17 *Leases* are needed and, if so, whether such changes should be made as part of the current leases project or as part of a separate project.

Joint lessee and lessor issues

Key tentative decisions common to lessee and lessor accounting since the release of the exposure draft, are outlined in the following pages.

The Boards have directed the staff to perform targeted outreach activities on the impact that these tentative decisions would have in practice. The staff plans to perform outreach activities in February and March and report back at the Boards’ April 2011 meeting.
**Definition of a lease**

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| The exposure draft defined a lease as a contract in which the right to use a specified asset, i.e. the underlying asset, is conveyed for a period of time, in exchange for consideration. The exposure draft retained the principal requirements of IFRIC 4 *Determining whether an Arrangement contains a Lease* regarding the identification of lease transactions. That is, a contract is or contains a lease if the following conditions are met:  
  - it conveys the right to use a specified asset; and  
  - it conveys the right to control the use of the underlying asset. | The Boards have considered the key conditions in the definition of a lease: a specified asset and control. For the specified asset criterion, the Boards plan to debate:  
  - whether a specified asset needs to be uniquely identifiable or can be defined more broadly as an asset of particular specification, e.g. whether, in order to be a lease, a contract must identify a car with a specified registration number, or merely identify a specific model of car within a fleet; and  
  - whether a physically distinct portion of a larger asset, or both a physical and a non-physical portion of a larger asset, can be a specified asset, e.g. a floor of an office building, or capacity on a fibre optic cable. In addition, the Boards clarified tentatively that a contract may identify explicitly or implicitly an underlying asset, but not contain a lease if the asset is incidental to the provision of a service. For the control criterion, a slight majority of Board members supported creating a revised description of control that is aligned with the proposals in the revenue exposure draft. The Boards plan to undertake outreach activities to seek feedback on such a model as well as an alternative model based more closely on the concept of control in IFRIC 4. |

**KPMG observations**

Since the release of the exposure draft the Boards have devoted a significant portion of the lease project redeliberations to issues around the definition of a lease. The definition of a lease in the exposure draft has come under more scrutiny than under current IAS 17 because the exposure draft requires a lessee to recognise all leases within scope on its balance sheet. Issues under consideration and to be deliberated further by the Boards include:  
- whether all leases are a form of financing;  
- how to distinguish between a lease and service contract and how to separate the lease element in a contract that contains both a lease and a service;  
- whether the current IFRS and US GAAP guidance is sufficient and appropriate to define a lease; and  
- whether a leased asset is a right-of-use asset, a physical or intangible asset, or a component/portion of a physical or intangible asset. The proposals that the Boards plan to explore further through outreach activities have the potential to move significantly the line between what is considered a lease and what is considered a service. For example, with respect to the specific asset test, if the Boards decide that a physically distinct portion of a larger asset can be a specified asset, then this will tend to increase the number of arrangements identified as leases. However, the introduction of an ‘incidental to services’ criterion may mean fewer assets are covered. In their redeliberations to date, a slight majority of both Boards have expressed a preference for the new standard to contain the more expansive definitions of a lease in the alternatives they are considering for the specified asset and control criteria. The Boards hope that additional outreach activities will help the Boards agree a path forward.
Types of leases

### Key proposals in the exposure draft

The exposure draft proposed that a lessee recognise:

- an asset for its right to use the leased asset and a liability for its obligation to make future lease payments; and
- amortisation of the right-of-use asset and finance expense arising on the liability.

The exposure draft proposed two accounting models for lessors: a performance obligation approach and a derecognition approach. If a lessor retained exposure to significant risks and benefits associated with the underlying asset, then it would apply the performance obligation approach to the lease; otherwise it would apply the derecognition approach to the lease. A lessor would decide which approach to apply to each lease, depending on the terms of the contract. Under both approaches, the lessor recognises an asset representing its right to receive future lease payments and interest income as there is a financing component to the arrangement that affects the pattern of profit or loss recognition.

### Results of post exposure draft deliberations

The Boards revisited whether there are different types of leases and decided tentatively that there are the following types of leases that should have different profit or loss recognition patterns:

- **Finance lease.** A lease that is similar to the lessor providing the lessee financing for the acquisition of an asset. The profit or loss pattern would be consistent with the proposals in the exposure draft.
- **Other-than-finance lease.** A lease that is similar to a rental transaction. Financing is not considered a significant component of the arrangement and the transaction is not similar to financing the acquisition of the asset. The profit or loss pattern would be consistent with current IAS 17 operating lease accounting, i.e. generally straight-line recognition.

The Boards propose to develop criteria to distinguish between finance and other-than-finance leases. Indicators may include consideration of:

- the residual asset
- potential ownership transfer
- the length of the lease term
- rent characteristics
- the underlying asset
- embedded or integral services
- variable rent.

### KPMG observations

The proposals that the Boards plan to explore through further outreach activities address concerns from constituents who believe that not all leases are the same, i.e. there are leases that are financing in nature and those that are not, and that a straight-line profit or loss recognition pattern is appropriate in some circumstances. The proposals also would further align the pattern of profit or loss recognition for lessees and lessors, as this pattern would depend on whether or not the lease is deemed to have a finance element.

Consistent with the exposure draft, all leases, including other-than-finance leases, would be on balance sheet for lessees. However, an additional test would be required to determine whether or not the lease expense should be recognised following a finance or other-than-finance approach. The Boards plan to include a principle for making this determination. By going down this path one cannot help but be concerned that the Boards are reintroducing the IAS 17 operating vs finance lease test, with all the complexity and subjectivity such a test entails.

Constituents concerned that the exposure draft did not meet the Boards’ stated objective of a single, principles-based, converged and less complex approach to lessee and lessor accounting are likely to see this as adding complexity to already complex proposals.
**Lease term**

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<td>The exposure draft proposed that the lease term be the longest possible term that is <em>more likely than not</em> to occur. Lease term would be assessed at inception of the lease and subsequently if facts or circumstances indicate that there has been a significant change in the lessee's lease liability or the lessor's lease receivable. The revised lease term would be assessed using the same criteria as the initial measurement.</td>
<td>The Boards decided tentatively that the lease term would be the contractual minimum lease term plus any optional periods for which exercise of the renewal option is <em>reasonably certain</em>. The assessment of whether exercise of a renewal option is reasonably certain would be based on economic factors. Similar to the exposure draft, the lease term would be reassessed on a basis consistent with the initial determination of the lease term. Given the tentative criteria to determine initial lease term, generally reassessment would only occur when economic factors affecting the decision to extend or terminate a lease change.</td>
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**KPMG observations**

Constituents responding to the exposure draft were concerned that the more likely than not threshold was too low and would result in complexity and implementation difficulties. Constituents called on the Boards to:

- revert to current guidance and apply a reasonably assured or reasonably certain threshold;
- increase the threshold to virtually certain; or
- include options to extend or cancel leases only when the contract includes incentives to exercise these options.

The direction of the Boards’ redeliberations is broadly responsive to this feedback. The tentative decision retains a generally understood recognition threshold, and also reduces the need for remeasurement by increasing the threshold from the relatively low more likely than not proposal in the exposure draft.

Whilst this approach retains a familiar and well understood threshold, the proposal also puts that threshold under additional pressure given all leases would be on balance sheet. The Boards are attempting to respond to this by expanding the definition of lease term to specify that the assessment of whether optional periods are reasonably certain to be exercised would be based on economic factors.

The Boards plan to provide criteria that would be used to assess whether economic factors suggest that renewal is reasonably certain, e.g. bargain renewal options, high costs of customisation or installation of the underlying asset, lease cancelation charges etc. Given the criteria would be based on economic factors as opposed to lessee-specific factors, it is more likely that lessees and lessors would make similar estimates of lease term than under the exposure draft’s proposed requirements. It will be interesting to see whether any new guidance on how to assess whether renewal is reasonably certain is consistent with current practice.
### Variable lease payments – initial measurement

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| The exposure draft proposed that for variable lease payments (contingent rentals) on initial recognition:  
  - recognise using an expected outcome technique, i.e. probability-weighted average;  
  - for lessors, include only expected outcomes that can be measured reliably; and  
  - if contingent rentals are based on an index or rate, use:  
    - forward rates if readily available; otherwise  
    - spot rates at inception of the lease. | The Boards’ decided tentatively that for contingent rentals on initial recognition:  
  - recognise all contingent rentals that are based on an index or rate using spot rates at inception of the lease;  
  - recognise all other contingent rentals but use a high recognition threshold, e.g. reasonably certain; the exact definition of that threshold to be determined; and  
  - introduce anti-avoidance measures designed to capture minimum lease payments that are ‘disguised’ as contingent rentals that would not otherwise be recognised. |

**KPMG observations**

Similar to the responses received for the lease term, constituents generally believed that the proposals for contingent rentals were overly complex and would be difficult to implement. Recommendations made to the Boards include:  
- providing a threshold for including contingent rentals in estimated lease payments such as reasonably assured, reasonably certain, or virtually certain;  
- measuring contingent rentals based on a best estimate approach rather than an expected outcomes approach;  
- excluding contingent rentals that are not based upon indices or rates from estimated lease payments; or  
- including only unavoidable contingent rentals in estimated lease payments.

Based on the direction of the Boards’ redeliberations, lessees and lessors still would be required to assess whether all contingent rentals meet the threshold for inclusion in the initial measurement of the lease payable and lease receivable, respectively.

However, the establishment of a threshold for recognition of contingent rentals that are not based on an index or rate will tend to reduce the amount of the lessee’s lease liability and the lessor’s lease receivable in comparison to the proposal in the exposure draft.

In addition, the Boards have yet to redeliberate the methodology to be used for measuring recognised contingent rentals other than those based on an index or rate and it is possible that the Boards will move away from an expected outcome technique to another approach such as a best estimate approach.

The Boards propose that some form of anti-avoidance measure be designed to capture minimum lease payments that are disguised as contingent rentals. However, the tentative decision to introduce a high recognition threshold for the recognition of contingent rentals not based on an index or rate should reduce the need for specific anti-avoidance measures.

The proposals would reduce the difference between a lessee’s estimated lease payable and a lessor’s lease receivable in some circumstances. However, differences in access to information still could result in substantially different estimates in certain types of leases, such as leases with payments based on a percentage of sales. Lessees are much more likely to be able to estimate their own sales and therefore the lease payment than a lessor would be. In this scenario, the lessee’s lease liability could be significantly different than the lessor’s lease receivable.
Other lease payment considerations

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<td>The exposure draft proposed that lease payments would:</td>
<td>The Boards reaffirmed tentatively a number of decisions regarding other lease payment issues included in the exposure draft. In particular, lease payments would:</td>
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<td>• not include an estimate of amounts payable/receivable under residual value guarantees (RVGs) provided by an unrelated third party;</td>
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<td>• include an estimate of the expected payment/receipt, i.e. the difference between the expected value of the asset at the end of the lease and the RVG, under RVGs that are not provided by an unrelated third party; and</td>
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<td>• include term option penalties.</td>
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KPMG observations

The Boards consider that RVGs are another form of contingent rental, and therefore the proposed requirements are consistent with the exposure draft and the current redeliberations on variable lease payments.

The Boards have yet to redeliberate the treatment of purchase options. The exposure draft specifically excludes purchase options from lease payments whereas under current IAS 17 the exercise price under a purchase option may be a lease payment in some cases.

The IASB’s website and the FASB’s website contain summaries of the Boards’ meetings, meeting materials, project summaries and status updates.

Abbreviations

1 IASB: International Accounting Standards Board
2 FASB: US Financial Accounting Standards Board